BEFORE THE

Federal Communications Commission

WASHINGTON, D.C.

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APR 1 7 1995

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation	))))	CC Docket No. 94-1

To: The Commission

COMMENTS OF
THE NATIONAL CABLE TELEVISION ASSOCIATION, INC.

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The National Cable Television Association, Inc. ("NCTA"), by its attorneys, hereby submits its comments to the Further Notice of Proposed Rulemaking ("FNPRM") in the above-captioned proceeding.

I. INTRODUCTION AND SUMMARY

Although the ostensible focus of the FNPRM is narrowly drawn upon the technical application of price cap regulation to video dialtone ("VDT") service, the questions really at issue are materially broader in scope.[1] The VDT controversies ultimately

[1] These comments assume that telephone companies will offer VDT. The recent comments in the Fourth Further Notice of Proposed Rulemaking, in which they almost uniformly insist upon the option to provide programming under the Cable Act model, suggests that they may be prepared to abandon VDT. To the extent that a telephone company operates pursuant to Title VI of the Communications Act, as opposed to the Title II VDT model, its rates should be subject to regulation under the Cable Act, not the Title II model.

require the FCC to respond to a fundamental regulatory challenge of the time: Supervision over the construction of the single most important network upgrade in the history of telecommunications.

The Commission now faces two issues central to the regulation of VDT service. First, the Commission must determine the initial price levels for VDT. This is a critically important undertaking. To settle it fairly and adequately, moreover, the Commission must finally make a clear policy decision regarding the extent to which it expects telephone ratepayers to bear the cost of the VDT facility.

Second, the Commission must determine the appropriate mechanisms for enforcing this policy judgment. In contrast to the subjectivity of the first issue, however, this issue is objectively straightforward. Briefly, the Commission should establish a separate price cap basket for VDT service that contains a price floor. The Commission should also exempt the VDT price cap basket from sharing. Finally, it should not try to apply a productivity factor to the VDT basket. In resolving this important but secondary set of issues, the Commission must not lose sight of the fact that it has yet to act upon the most fundamental issue: Who will pay for VDT?

II. IT IS CRITICALLY IMPORTANT THAT THE COMMISSION EXPLICITLY DECIDE WHO WILL BEAR THE COSTS OF VDT BEFORE THE INITIAL PRICE CAP LEVELS FOR VDT ARE SET

The most important task the Commission faces in the regulation of VDT service is the establishment of the initial price levels for VDT. Given this, NCTA respectfully submits that this proceeding necessarily assumes that the most significant and most difficult of its VDT regulatory responsibilities have been fulfilled. That is, of course, not the case. The FCC has relegated to the circumscribed tariff process that all-important task.

Given the sheer size of the investment at issue, it is critical that the Commission set VDT prices fairly. This can be accomplished, however, only if the Commission makes an explicit policy judgment regarding the extent to which telephone ratepayers will bear the costs of building the VDT network. This decision will lend coherence to virtually all other aspects of VDT proceedings, including the establishment of a separate price cap basket for VDT.

In the Reconsideration Order[2], the Commission began to address the allocation issue. Thus, it acknowledged there that the costs attributed to VDT in the VDT tariffs should include a certain percentage of shared plant costs.[3] It then went on to state that "[w]e recognize and accept the challenges inherent in determining which costs are truly the consequences of a carrier's

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[2] Amendments of Parts 32, 36, 61, 64, and 69 of the Commission's Rules to Establish and Implement Regulatory Procedures for Video Dialtone Service, Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, 19 FCC Rcd. 244 (1994) ("Reconsideration Order").

[3] See id. at ¶ 217.

decision to provide video dialtone service . . . ."[4] Even in these statements, however, it is evident that the problem that has plagued the FCC's approach to the allocation issue continues to linger. For despite its avowed desire to face that problem, the Commission seems still to believe that principles of accounting and economics hold the answer. But this is simply not so.

Throughout the VDT proceedings, the Commission has tended to hide behind the veil of "scientific" objectivity, acting as if there is one necessary answer to the allocation question. But the application of accounting concepts such as "incremental" or "direct" cost cannot lead to any single, correct answer. This is because these terms are essentially contingent. They are useful only when understood with reference to fundamental value judgments.[5] Thus, until the Commission explicitly decides how much of the cost of VDT should be borne by telephone ratepayers, and defines the terms of the debate accordingly, this issue will remain unresolved.

The consequences of the Commission's failure to define its terms is best illustrated by the confusion over what costs are

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4 Id.

5 See Alfred E. Kahn, The Economics of Regulation, Principles and Institutions at 70-86 (1989) (discussing the measure of incremental cost and concluding that "[s]ince the best probable compromise of offsetting considerations will clearly vary from one pricing context to another, it is impossible to set forth an integrated, general set of conclusions. Instead what we have is really a set of hypotheses, of relevant considerations.").

"incremental" to VDT. Since the Commission has determined that VDT prices must, at a minimum, cover the incremental costs of VDT,[6] resolution of this difference is fundamental to the allocation judgment as it has so far been defined.

The debate over the Bell Atlantic Dover Township tariff[7] provides the most important example of the different views as to what costs are incremental to VDT. In its Dover tariff, Bell Atlantic characterizes much of the cost of its VDT system as essentially "sunk" costs in connection with the provision of telephone service. By thus attributing a large proportion of its cost to telephone service, Bell Atlantic is able to rationalize relatively low VDT prices.

But Bell Atlantic's view is, of course, not uncontroversial. NCTA believes that VDT should not be viewed as essentially a new service to be provided over an existing network, but rather as the addition of almost an entirely new facility. This is so because the broadband network is necessary for the delivery of video but not of voice. The "increment" in VDT is the entire broadband network, i.e., all costs in excess of the present network.

This controversy cannot simply be resolved by referring to general notions of "incremental" cost. Rather, it requires careful, explicit FCC definition as to what should be viewed as

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6 See Reconsideration Order at ¶ 217.

7 Bell Atlantic Tariff F.C.C. No. 10, Transmittal No. 741 (January 27, 1995).

the base and what should be viewed as the increment. Only the Commission possesses the authority to establish such a standard. Until it does so, however, the debate will remain unresolved, public policy will be determined by default, and the risk of vastly different regulatory treatment of similarly situated industries will remain great.

III. THE COMMISSION SHOULD ESTABLISH A SEPARATE PRICE CAP BASKET FOR VDT WHICH CONTAINS A LOW END PRICE FLOOR

The Commission's resolution of the question of who will pay for the broadband network is crucial; that decision will be reflected in the initial price levels allowed to be charged by telcos. The policy decisions inherent in those prices must be continuously reaffirmed through ongoing pricing supervision. In order to maintain meaningful regulatory oversight, the Commission must establish a separate price cap basket for VDT. The reason for this is obvious. Including VDT in the existing baskets would allow telcos to lower VDT prices and raise the prices of other services in the same basket to compensate. The resulting cross-subsidy would subvert any allocation judgment the Commission makes. This kind of misallocation can, however, be avoided by creating a separate VDT price cap basket.

The Commission's decision to establish a separate basket for interexchange service offers a compelling precedent for the creation of a VDT basket. In the interexchange case, the Commission determined that, since the service was very different from and served very different customers than access services, a separate interexchange basket should be established to avoid cross-subsidy.[8]

Similarly, VDT is a very different service that will serve potentially very different customers, than services in other baskets. The simple fact that VDT service delivers video completely distinguishes it from the voice services in other baskets. To avoid the cross-subsidy problems that, as the Commission recognized,[9] almost inevitably arise in such a situation, a separate VDT price cap basket should be created.

Moreover, the addition of a price floor for VDT would also help to inhibit telcos from cross-subsidizing the cost of VDT. The concern with cross-subsidy, of course, is that prices in the subsidized business will be too low rather than too high. A price floor would at least help to inhibit VDT providers from setting VDT prices at inefficiently low levels.[10]

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[8] See Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd. 6786 at ¶ 213 (1990).

[9] See id.

[10] NCTA is aware that the Commission sought comment in the FNPRM on whether to place VDT in a larger broadband services price cap basket. NCTA opposes the creation of a broadband basket. In the event that one is created, however, it is crucial that the Commission isolate VDT service within the basket in its own band.

Moreover, NCTA is also aware that the Commission is considering the merits of dividing VDT service within the basket into subelements. NCTA believes this is an important proposal, however, at this stage the tariff process has yet to create any stable set of rate elements. Once these are established, the proposal can be more readily reviewed.

IV. THE VDT BASKET SHOULD BE EXEMPT FROM SHARING

The sharing mechanism for interstate access service poses a special threat to the cross-subsidy protection of a separate VDT price cap basket. Indeed, inclusion of the VDT basket in sharing would undermine the very reason for establishing a VDT basket in the first place by creating significant opportunities to cross-subsidize the cost of VDT. VDT should therefore be exempt from sharing.

Sharing permits cross-subsidy because the rate of return used in the sharing mechanism is calculated for all regulated interstate services together. Thus, if a telco's interstate rate of return falls below the lower adjustment band, it is entitled to a price increase prorated across all services. If a telco's VDT service loses money, therefore, other service prices can be increased to compensate. Conversely, if, except for VDT's performance, a telco's rate of return would exceed the upper adjustment band, VDT's poor performance would effectively deny telephone ratepayers a rate reduction.[11]

The logical way to prevent telcos from gaming the sharing mechanism to misallocate the costs of VDT is to insulate other price cap baskets from the effects of VDT earnings. This requires that VDT revenues, investment and expenses be removed

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[11] This analysis might change somewhat to the extent a telco is exempt from sharing but not from continued rate of return reporting and monitoring. Even if a telco were exempt from sharing, however, cross-subsidy would still be a problem due to the incentives created by future price cap reviews and continued reporting and monitoring.

from the current interstate rate of return calculation. If the Commission neglects to do this, much of the benefit of a separate price cap basket will be lost.

The need to remove VDT, in turn, may require the Commission to amend Part 69. Currently, the costs of services in the existing baskets are allocated pursuant to a separations-based formula. As discussed in Section I, supra, the Commission has yet to establish any material cost allocation rules for VDT. Moreover, to the extent the allocation methods eventually used and approved for VDT are not separations-based, the implications for using two different methods for VDT price regulation (i.e., one to establish initial prices, a second to cost out VDT from sharing) must be considered. It seems highly likely that this could facilitate far greater burdens on captive ratepayers than sound policy would allow. Thus, while NCTA firmly supports the Notice's proposal to keep VDT out the sharing mechanism, the process of doing so is fairly complicated and will require careful attention.

V. THE COMMISSION SHOULD NOT APPLY A PRODUCTIVITY FACTOR TO VDT

In the past, the Commission has applied a productivity factor only where it could demonstrate that a service possessed a long, established record of increases in productivity in excess of the national average. Thus, the long distance and local access services to which the Commission has applied a productivity factor had been provided by the Bell System and then

AT&T and the local exchange carriers for the better part of a century. Moreover, in deciding whether and at what level to apply productivity factors to these services, the Commission relied on numerous, detailed studies of the companies' and the industry's total factor productivity.[12] Indeed, the Commission repeatedly emphasized the importance of this kind of historical evidence:

> the use of a number that is grounded in long term historical experience reflects the fact that, while productivity may change from year to year in response to a number of factors, a long term average is more likely to bear a closer relationship to the level of productivity in the future than would predictions based on short term experiences, even recent experience.[13]

In contrast to traditional long distance and local access services, however, the telephone companies have never provided VDT service before. Thus, the Commission has no record of industry or firm productivity upon which to rely in this proceeding. Even if the Commission could determine that VDT

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[12] See Policy and Rules Concerning Rates for Dominant Carriers, Further Notice of Proposed Rulemaking, 3 FCC Rcd. 3195 at ¶¶ 368-378 (1988) (determining that productivity for AT&T and local exchange companies ("LECs") are fundamentally the same and relying on (1) study of Bell System's productivity from 1947-78 performed by consultant to AT&T, (2) AT&T internal study of Bell System productivity from 1948-78, (3) Nadiri and Schankerman study of four-factor productivity within the Bell System, (4) two-factor productivity studies of the communications industry produced by the American Productivity Center covering 1948-85, (5) Labor Department studies of telephone services from 1955-85, (6) Bellcore study of interstate access charges from 1984-86, and (7) changes in AT&T prices since divestiture).

[13] Policy Rules Concerning Rates for Dominant Carriers, Supplemental Notice of Proposed Rulemaking, 5 FCC Rcd. 2176 at ¶ 23 (1990).

would, in the future, experience productivity gains that exceed the national average, it has no way of measuring the extent of this excess. It is therefore inappropriate for the Commission to apply a productivity factor to VDT.

VI. CONCLUSION

For the reasons described above, NCTA respectfully requests the Commission to establish a separate price cap basket for VDT service with a price floor, to exempt the VDT basket from sharing as well as the application of a productivity factor.

Respectfully submitted,

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April 17, 1995

CERTIFICATE OF SERVICE

I, Thomas Jones, do hereby certify that on this 17th day of April, 1995, copies of the foregoing "Comments of the National Cable Television Association, Inc." were delivered by hand, unless otherwise indicated, to the following parties:

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